

# Measuring Risk-Sharing Finance: Evidence From Uzbekistan And Islamic Banking Practices

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**ABSTRACT**

This study examines the extent of risk-sharing finance in Islamic banking by analyzing the composition of bank assets and constructing a Risk-Sharing Finance Friendliness Index (RSFFI) for Uzbekistan. The findings reveal that risk-sharing instruments constitute a very small share of total Islamic banking assets across countries, with risk-shifting, debt-like instruments dominating in practice. Even in leading countries, the adoption of profit-and-loss sharing mechanisms remains limited. The RSFFI results indicate that Uzbekistan has a below-average level of readiness, primarily constrained by underdeveloped financial markets despite relatively stronger institutional and legal conditions. These results highlight the importance of financial sector development and institutional strengthening to promote risk-sharing finance.

**Keywords:**

**Introduction**

Islamic finance is a financial system grounded in Shariah principles, where the central objective is not the transfer of risk to a single party but its equitable distribution among participants engaged in economic activity. In contrast to conventional debt-based finance—where risk is largely shifted to the borrower and the lender secures a predetermined return—Islamic finance is built upon the principle of profit-and-loss sharing (PLS), which aligns the incentives of capital providers and entrepreneurs. Core instruments such as mudarabah and musharakah embody this framework by linking returns to actual business performance, while sukuk structures further reinforce risk-sharing through asset-backed financing tied to the real sector.

This theoretical foundation has led many scholars to position Islamic finance as a more inclusive, efficient, and stable alternative to conventional finance. Recent global trends also highlight the rapid expansion of the industry, with total Islamic finance assets exceeding 4–5

trillion USD (Mordor Intelligence, 2025) and projected to continue growing at a steady pace. Innovations such as green sukuk, fintech-based Islamic crowdfunding, and tokenized Islamic instruments are increasingly being introduced, suggesting a potential revival of risk-sharing principles. However, despite these developments, the structure of Islamic finance remains heavily skewed toward debt-like instruments.

In practice, Islamic financial institutions rely predominantly on fixed-return, trade-based contracts such as murabaha and ijara, which closely resemble conventional lending mechanisms. As noted by Abbas Mirakhor (Mirakhor, 2016), Islamic finance is conceptually designed as a partnership-based system closely linked to real economic activity. Yet empirical evidence consistently shows that profit-and-loss sharing instruments constitute only a small fraction of total Islamic banking assets. This divergence raises critical concerns regarding whether Islamic finance operates as a

genuine risk-sharing system or has effectively converged toward risk-shifting models.

The gap between theory and practice remains particularly underexplored in emerging economies, where institutional quality, financial market development, and regulatory frameworks play a decisive role in shaping financial structures. To address this gap, this study introduces a composite Risk-Sharing Finance Friendliness Index (RSF Index) and applies it to the case of Uzbekistan. The results indicate that Uzbekistan's RSF index stands at approximately 0.35, suggesting a below-average level of readiness for risk-sharing finance.

Furthermore, using data from the Islamic Financial Services Board (IFSB, 2024), the study analyzes the composition of Islamic banking assets across countries and finds that risk-shifting instruments dominate over equity-based modes of financing. This evidence supports the argument that, despite its theoretical distinctiveness, Islamic finance is increasingly influenced by the same structural and institutional constraints that shape conventional financial systems.

Against this backdrop, the paper investigates the extent to which Islamic finance reflects a true risk-sharing paradigm and examines the institutional and market factors that limit its development. By combining an index-based approach with cross-country evidence, the study contributes to the broader debate over whether Islamic finance can serve as a viable alternative to conventional finance or is evolving toward similar risk-allocation dynamics.

### Literature review

Islamic finance is theoretically grounded in the principle of profit-and-loss sharing (PLS), positioning it as a risk-sharing financial system that aligns the interests of capital providers and entrepreneurs. In contrast to conventional debt-based finance, where risk is largely transferred to the borrower, Islamic finance promotes joint participation in both profits and losses through instruments such as *mudarabah* and *musharakah*. This theoretical foundation has led to a substantial body of literature characterizing Islamic finance as a more stable, equitable, and efficient financial system.

However, empirical evidence reveals a significant divergence between theory and practice. Contemporary Islamic financial systems are dominated by debt-like instruments such as *murabaha* and *ijara*, which provide predetermined returns and closely resemble conventional lending structures. This shift away from genuine risk-sharing has been widely discussed in the literature, with agency theory offering a central explanatory framework.

According to Michael C. Jensen and William H. Meckling (1976), financial contracts are shaped by conflicts of interest between principals (investors) and agents (entrepreneurs), particularly under conditions of information asymmetry. In equity-based contracts, returns depend on realized profits, which are privately observed by the entrepreneur. This creates significant agency problems, including moral hazard and the risk of profit misreporting. As a result, investors incur substantial monitoring and verification costs. In the context of Islamic finance, PLS instruments such as *mudarabah* and *musharakah* inherently involve these agency costs, making them relatively complex and costly to implement.

These challenges are further exacerbated in environments with weak institutional frameworks. When legal enforcement is limited, contract execution is uncertain, and auditing standards are insufficient, investors face difficulties in verifying actual business performance. This increases the perceived risk of equity-based financing and discourages its use. Consequently, Islamic financial institutions tend to prefer instruments that minimize monitoring requirements, such as *murabaha*, where returns are fixed in advance and risk is largely transferred to the client.

The role of institutions in shaping financial structures is strongly emphasized in the work of Rafael La Porta et al. (1998), who show that investor protection and the quality of the legal system are key determinants of financial development. Their findings suggest that countries with strict rule of law and effective enforcement mechanisms tend to have deeper equity markets and greater reliance on external financing. In such environments, risk-sharing arrangements become more feasible,

supporting the development of venture capital and other equity-based financing mechanisms. Conversely, weak institutional environments tend to reinforce debt-based financing structures.

A critical perspective on the evolution of Islamic finance is provided by Mahmoud A. El-Gamal (2006), who argues that many Islamic financial instruments are “Shariah-compliant” in form but economically equivalent to conventional debt contracts. He attributes this convergence to regulatory pressures, risk aversion among investors, and financial institutions’ desire to maintain predictable income streams. From this perspective, Islamic finance has undergone a process of “functional mimicry,” where the substance of transactions increasingly resembles risk-shifting rather than risk-sharing. Similarly, Hossein Askari et al. (2010) highlight that the stability advantages of Islamic finance are closely tied to its risk-sharing features. However, they also acknowledge that in practice, financial institutions tend to avoid PLS contracts due to high information asymmetry and monitoring costs in real-sector investments. This leads to a structural preference for less information-intensive instruments.

Finally, Abbas Mirakhor conceptualizes Islamic finance as an ideal risk-sharing system that enhances macroeconomic stability by linking finance to real economic activity. Nevertheless, he recognizes that the limited adoption of risk-sharing instruments is largely driven by institutional weaknesses. According to Mirakhor, effective implementation of risk-sharing finance requires strong legal systems, transparent reporting standards, and robust governance frameworks.

Overall, the literature suggests that the prevalence of debt-like instruments in Islamic finance is not merely a deviation from theory, but a rational response to agency problems and institutional constraints. The interaction between information asymmetry, monitoring costs, and legal environment plays a decisive role in determining the structure of financial contracts. Therefore, measuring the extent of risk-sharing finance requires not only an analysis of financial instruments but also a careful consideration of the underlying

institutional context in which these instruments operate.

### **Methodology**

This study employs a quantitative, index-based approach to assess the extent of risk-sharing finance within the Islamic banking sector, with a particular focus on Uzbekistan. The empirical analysis is primarily based on data obtained from the Islamic Financial Services Board (IFSB), which provides standardized and cross-country comparable statistics on Islamic banking assets and their composition. Using this dataset, the study decomposes Islamic banks’ total assets into two broad categories: risk-sharing (equity-based) instruments—such as *mudarabah* and *musharakah*—and risk-shifting (debt-like) instruments, including *murabaha*, *ijara*, and other fixed-return structures. This classification allows for the construction of a relative measure of risk-sharing intensity by calculating the share of profit-and-loss sharing (PLS) assets within total Islamic banking assets. The first stage of the methodology involves a descriptive and comparative analysis of asset composition, aiming to identify the dominance of risk-shifting instruments over risk-sharing ones. This provides an empirical foundation for assessing the gap between the theoretical model of Islamic finance and its practical implementation. The analysis is conducted over available time-series data to capture structural trends and persistence in asset allocation patterns.

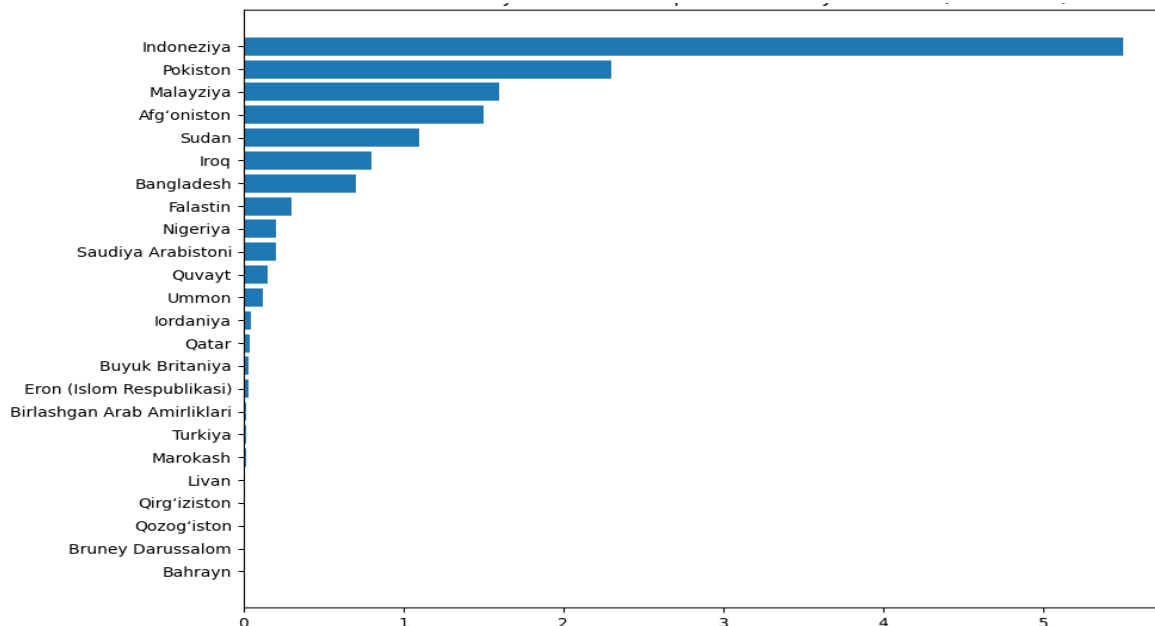
In the second stage, the study extends the analysis by constructing a country-specific “Risk-Sharing Finance Friendliness Index” (RSFFI) for Uzbekistan, following the framework proposed by Akin et al. (2016). This composite index is designed to evaluate how conducive a country’s financial and institutional environment is to the development of risk-sharing finance. The index incorporates multiple dimensions, including financial sector structure, legal and institutional quality, financial market development, and access to equity-based financing mechanisms.

For Uzbekistan, relevant indicators are selected and adapted based on data availability and contextual relevance. These include proxies for rule of law, investor protection, capital market

development, financial inclusion, and the relative size of equity-based financing. Where necessary, indicators are normalized using min-max transformation to ensure comparability and aggregation into a single composite index.

**Results and Discussion**

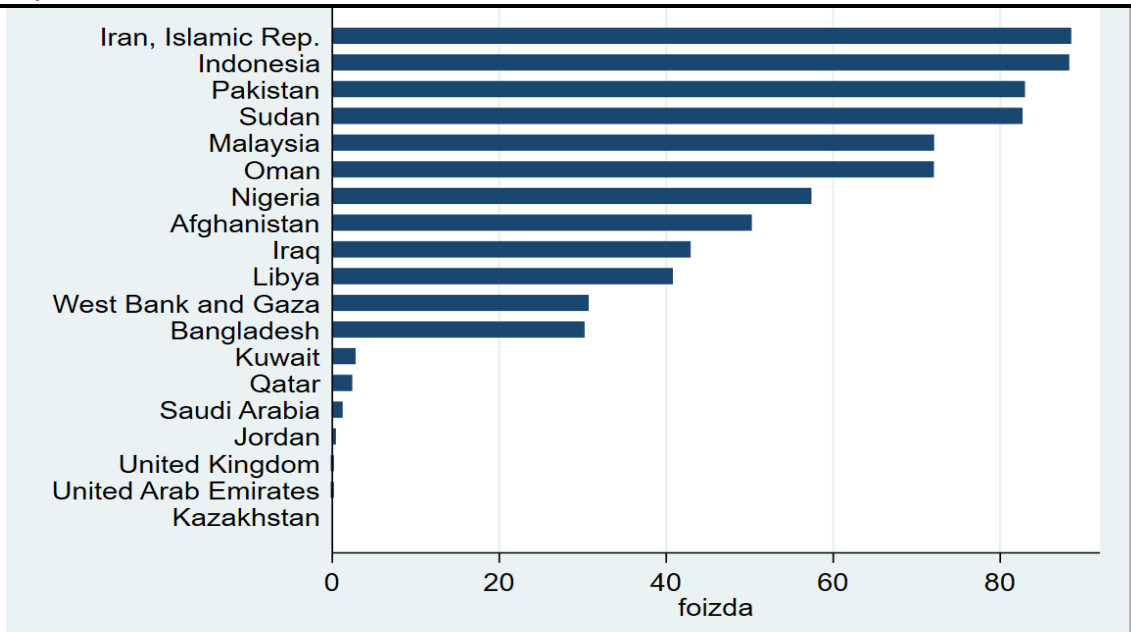
The resulting RSFFI score enables both an internal assessment of Uzbekistan’s readiness for risk-sharing finance and a basis for future cross-country comparison.



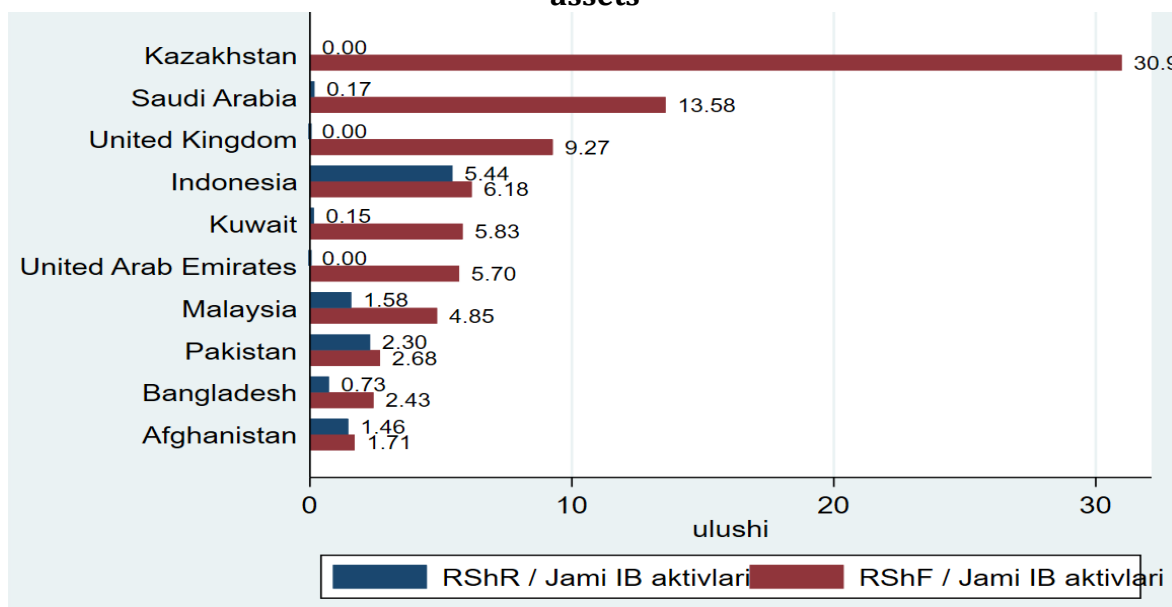
**Figure 1. Top Countries by the Share of Risk-Sharing Instruments in Total Islamic Banking Assets**

This figure illustrates the share of risk-sharing instruments within total Islamic banking assets across different countries over the period 2013–2024. The results indicate that Indonesia records the highest share, followed by Pakistan, Malaysia, and Afghanistan. In these countries, the relatively more active use of instruments such as mudarabah and musharakah suggests a

comparatively wider adoption of risk-sharing finance. However, despite this relative leadership, the overall share of risk-sharing instruments remains below 5% of total Islamic banking assets, indicating a very limited role in practice.



**Figure 2. Top Countries by the Share of Risk-Sharing Instruments in Islamic Banks' Islamic Assets**



**Figure 3. Countries with the Largest Gap Between Risk-Sharing and Risk-Shifting Instruments in Islamic Banking Assets, (%)**

This figure 2 presents the share of risk-sharing instruments among total Islamic financial instruments of Islamic banks, expressed as a percentage, and includes only countries with relatively high values. In many countries, this share is either very low or even negligible. The results show that countries such as Iran, Indonesia, and Pakistan exhibit comparatively higher shares of risk-sharing instruments, indicating that profit-and-loss sharing mechanisms play a more significant role in their Islamic financial systems. In contrast, in several other countries, the share remains minimal,

suggesting that Islamic risk-sharing instruments are used only to a limited extent in banking activities.

This figure 3 shows the leading countries by the share of risk-shifting financing in total Islamic banking assets. The results indicate that in countries such as Kazakhstan, Saudi Arabia, and the United Kingdom, risk-shifting instruments—such as murabaha and other debt-like structures—constitute a substantial portion of bank assets. This suggests that, in many jurisdictions, Islamic banking systems in practice rely predominantly on financing

instruments that closely resemble conventional debt-based models.

**Table 1. Structure of the Risk-Sharing Finance Friendliness Index (RSFFI, Akin et al., 2016)**

<b>A. Institutional scaffolding</b>	<b>B. Governance and Legal Environment</b>	<b>C. Financial Sector Development</b>	<b>D. Multidimensional Inclusion</b>
1. Information Quality and Cost	1. Legal System	1. Overall Development	1. Economic Inclusion
2. Property Rights	2. Corporate Governance	2. External Financing	2. Financial Inclusion
3. Contract Enforcement	3. Regulatory Quality	3. Alternative Risk-Sharing Instruments	3. Social Exclusion
4. Trust			
5. Commitment			

The Risk-Sharing Finance Friendliness Index (RSFFI) developed by Akin et al. (2016) is a multidimensional composite index designed to assess how supportive a country’s environment is for the development of risk-sharing finance. The index is structured around four main pillars, each capturing a key dimension of the financial and institutional ecosystem.

**Table 2. Sub-Indices Forming Uzbekistan’s Risk-Sharing Finance Friendliness Index**

<b>Sub-Index Name</b>	<b>Weighted Average (Log)</b>	<b>Transformed Score</b>
Institutional Foundation	-0.9308	0.3942
Governance and Legal Environment	-0.5529	0.5753
Financial Development	-1.7545	0.1730
Inclusion	-0.8963	0.4081
<b>RSFF Index</b>	<b>-1.0336</b>	<b>0.3560</b>

The table indicates that the Institutional Foundation sub-index (0.39), although relatively low, suggests a generally stable institutional infrastructure. The Governance and Legal Environment (0.57) is the highest-rated dimension, reflecting comparatively stronger performance in legal and regulatory frameworks. In contrast, Financial Development (0.17) is the weakest sub-index. Indicators such as stock market capitalization, trading activity, and venture capital availability remain very low, highlighting the financial system's limited capacity to support risk-sharing through market-based instruments. The Inclusion sub-index (0.40) is moderate. While there has been progress in access to banking services, human rights, and gender equality, factors such as low credit card ownership and unemployment rates have negatively affected the overall score. The

overall index value, RSFFI = 0.35, is measured on a scale from 0 to 1. A score of 0.35 indicates a below-average level of readiness for risk-sharing finance. This suggests that while Uzbekistan has some institutional and regulatory foundations to support the development of Islamic finance and risk-sharing mechanisms, the availability and active use of financial instruments remain significantly constrained.

**Conclusion**

Based on the two figures and the final table, it is evident that risk-sharing finance remains marginal within Islamic banking systems across countries, with its share generally not exceeding 5% of total assets. Even in leading countries such as Indonesia, Iran, and Pakistan, the use of profit-and-loss sharing instruments is relatively

limited compared to debt-like structures. The dominance of risk-shifting instruments in countries like Kazakhstan, Saudi Arabia, and the United Kingdom further confirms the practical reliance on fixed-return financing models.

The RSFFI results for Uzbekistan (0.35) reinforce this pattern, indicating a below-average level of readiness for risk-sharing finance. While the country demonstrates relatively strong governance and legal conditions, the underdevelopment of financial markets significantly constrains the adoption of equity-based instruments. Overall, the findings suggest that strengthening financial-sector depth and expanding the use of market-based instruments are critical to advancing risk-sharing finance.

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